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No. 83-555

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

RUSSELL STOVER CANDIES, INC.
a Missouri corporation,

Appellant,

— v —

DEPARTMENT OF REVENUE OF THE STATE OF MONTANA,

Appellee.

On Appeal from the Supreme Court of Montana

BRIEF IN OPPOSITION TO MOTION TO DISMISS APPEAL

WARD A. SHANAHAN
Counsel of Record
DANIEL C. MURPHY
301 First National Bank Building
P.O. Box 1715
Helena, MT 59624-1715
(406) 442-8560

Counsel for Appellant

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The Appellant submits the following brief in opposition to the Appellee's Motion to Dismiss Appeal.

SUBSTANTIAL FEDERAL QUESTIONS ARE RAISED

The Appellee's Motion does not rebut the Appellant's position that substantial federal questions requiring plenary consideration by this Court are raised in this case. Indeed, in recognizing that the facts of this case are unlike those involved in any prior decisions of this Court, Appellee has admitted that its position represents a significant extension of the unitary business principle. In addition, the Department has not supported its position that the income allocated to Montana by application of the

three-factor formula is related to the intrastate values of the Appellant's activities. As such, the position of the Appellee raises substantial federal questions which should be fully addressed by this Court.

A. *The Department's Application of the Unitary Business Principle to the Appellant's Operations is Constitutionally Impermissible.*

The Appellee's application of the unitary business principle to the Appellant's business operations is an attempt to extend the taxing power of the State of Montana beyond its borders and to expand the unitary business principle. Appellee recognizes that this case presents a factual situation that is "somewhat unique in that it involves the activities of a company operating in more than one type of business." Appellee's Motion to Dismiss Appeal (hereinafter Motion), p. 5. The unitary business principle has never been sanctioned for use where a business organization engages in two distinct business activities which are functionally separate and connected only by common ownership, minimal administrative ties and a resulting flow of funds.

In all recent cases involving the unitary business principle, this Court has addressed situations where the taxpayer's operations within the taxing state were substantially identical to, or part of an integrated operation with, its activities outside the taxing state. Here, the Taxpayer's business operations within the taxing state are totally distinct and separate from its operations outside the state. There is no operational link, other than that provided by common ownership, minimal administrative ties and a flow of funds, between the Taxpayer's in-state and out-of-state activities. The application of the unitary business principle to this Taxpayer's operations represents an extension of the unitary business principle and raises a

substantial federal question meriting this Court's further consideration.

The federal issue raised here is especially significant as the factors relied upon by the Department to justify its application of the unitary business principle have been previously addressed by this Court and found insufficient to constitute a unitary business. In *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. ____, 102 S. Ct. ____, 73 L. Ed. 2d 787 (1982), and *F.W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico*, 458 U.S. ____, 102 S. Ct. ____, 73 L. Ed. 2d 819 (1982), this Court dealt with all of the factors relied upon by the Department here to justify its position. In so doing, the Court found that control of major management or financial decisions did not evidence a unitary business. *F.W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico*, 73 L. Ed. 2d at 831; *ASARCO, Inc. v. Idaho State Tax Commission*, 73 L. Ed. 2d 801, n. 22.

Further, the provision of centralized services by a parent to a subsidiary was found insufficient to link what otherwise would be distinct business operations. *F.W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico*, 73 L. Ed. 2d at 831, n. 22. Finally, reliance upon a transfer of funds between the subsidiary and the parent to justify unitization was held to be a subversion of the unitary business principle. *F.W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico*, 73 L. Ed. 2d at 827, n. 11. The factors relied upon by the Department here have been addressed by this Court. The statements of this Court regarding these factors have been ignored by both the Department and, more importantly, by the Montana Supreme Court in its decision following remand.

In view of the fact that the Montana Supreme Court, in its decision following remand, ignored the opinions of this Court in *ASARCO* and *Woolworth*, it is apparent that the Montana court has not applied the correct standards to the facts of this case. While the Montana court correctly set forth general principles concerning the unitary business principle, it did not apply the guidelines of this Court contained in *ASARCO* and *Woolworth*. Further, in light of the "unique" facts of this case, the decision of the Montana court, holding that the Appellant's business operations constitute a unitary business, falls outside of the realm of permissible judgment and violates the due process guarantees of the Fourteenth Amendment to the United States Constitution.

The Department argues that the operation of the box divisions, *inter se*, and the manner in which the Appellant reports its income in other states, are of great significance for this case. Motion, pp. 6-9. However, the issue involved here is the taxing authority of the State of Montana. Due process analysis focuses upon the business activities of the taxpayer within the taxing state and their connection with the activities of the taxpayer outside the taxing state. *Mobil Oil Corporation v. Commissioner of Taxes*, 445 U.S. 425, 442 (1980); *Exxon Corporation v. Wisconsin Department of Revenue*, 447 U.S. 207, 223 (1980). The relationship of the Taxpayer's various out-of-state activities to one another cannot affect the constitutional limitations upon the taxing authority of the State of Montana. The manner in which the Taxpayer reports its income in other states is similarly irrelevant.

In discussing the operations of the Taxpayer's box divisions, the Department argues that the box divisions had no joint advertising program, no common salesmen, no common guarantees, and did not purchase materials jointly.

Motion, p. 7. What is not stated is that there was no advertising program at all for any of the box divisions and no salesmen for any of the divisions. Transcript, Vol. 1, pp. 171-172. Further, the Department states that "the box divisions did not purchase materials jointly" and cites Transcript, Vol. 1, pp. 171-174. Motion, p. 7. The Transcript, to the contrary, reveals that four of the box divisions had a common purchasing agent. On the other hand, the ranches made their own purchases. Transcript, Vol. 1, pp. 106, 174.

More importantly, Appellee failed to mention that all of the box divisions had a common interchange of equipment and technical services. Transcript, Vol. 1, pp. 172-173. (Transcript pp. 171-174 have been attached as Appendix E.) This was not the practice with the Montana ranch divisions. Transcript, Vol. 1, pp. 106, 109. Most significantly, the paper box divisions all produced paper boxes and related materials. Thus, if relevant, the box divisions are plainly unitary among themselves. That conclusion does not mandate a determination that the ranch divisions are unitary with the box divisions or even affect the question. The connections which exist between the ranch divisions and the box divisions are the significant issue. Those connections are insufficient to justify a conclusion that the ranch divisions are part of a unitary business which includes the box divisions.

Moreover, the manner and method in which the Appellant files its tax returns in other states cannot confer constitutional propriety upon the position taken by the Montana Department of Revenue in this case. As this Court has stated, the constitutionality of a state tax does not depend upon the vagaries of another state's tax policy. ***Mobil Oil Corporation v. Commissioner of Taxes***, 445 U.S. at 444; ***Exxon Corporation v. Wisconsin Department***

of Revenue, 447 U.S. at 228-229. The actions of other states in applying the unitary business principle or of the Appellant in filing in other states as a unitary business cannot convert an otherwise unconstitutional extension of a state's taxing power into a constitutionally permissible exercise of that power.

The Department has argued that the facts of this case are clearly distinguishable from the facts presented in *ASARCO* and *Woolworth* and are more consistent with the facts contained in *Container Corporation of America v. Franchise Tax Board*, 51 U.S.L.W. 4987 (1983). Each of those cases is factually distinct from this case. All of them involved business operations in the taxing state which were substantially similar to or integrated with business operations outside the taxing state. *Woolworth* involved foreign subsidiaries engaged in the same retail sales business conducted by the parent in this country. *F.W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico*, 73 L. Ed. 2d at 828. *ASARCO* involved subsidiaries which were engaged in mining, milling, smelting and refining of nonferrous metals or in the fabrication and manufacture of metal products. *ASARCO, Inc. v. Idaho State Tax Commission*, 73 L. Ed. 2d at 791, n. 2. *Container* involved a vertically-integrated parent corporation engaged in manufacturing custom-ordered paperboard packaging. Its foreign subsidiaries were all engaged in their local markets in essentially the same business. *Container Corporation of America v. Franchise Tax Board*, 51 U.S.L.W. at 4990. Further, except for the provision of operating funds, none of the factors relied on by the court in *Container* is present in this case. Here, the corporate home office does not provide assistance to the ranching operations in equipment interchange or purchases or in filling personnel needs. Further, the home office does not provide technical

assistance to or play a supervisory role in day-to-day operations of the Montana ranching operations. Therefore, this case is substantially different from all three cases. The Taxpayer's ranching operations are totally dissimilar from its paper box production activities. Its ranching operations are not vertically integrated at any functional level with the operations of the paper box divisions.

The Appellant's ranching operations are discrete business enterprises. Indeed, if those operations are not discrete enterprises, then nothing is likely to qualify for the designation. The ranching operations are separated from the paper box operations in every meaningful sense. They are joined only by common ownership and the connections which arise therefrom. The provision of administrative services, the control of major management decisions, and a flow of funds between the home office and the ranching divisions are not sufficient to convert the ranching operations into aspects of a unitary business. Decisions to the contrary, left unchallenged, remove all effective limitation upon the unitary business principle. In such an instance, a "discrete business enterprise" would be possible only through complete organizational separation, leaving only stock ownership as a possible connector.

For these reasons the issue of the applicability of the unitary business principle to the Taxpayer's operations located within and outside the State of Montana presents a substantial federal question which merits plenary consideration by this Court.

B. *Income Allocated to Montana by Use of the Three-factor Formula is not Rationally Related to the Intrastate Values of the Taxpayer's Enterprise.*

The Appellant maintains that the three-factor formula applied by the State of Montana to its operations, located

both within and outside the State of Montana, has produced an allocation of income to the State of Montana which is out of all appropriate proportion to the business transacted by the Appellant in Montana. The formula applied by the Department of Revenue has allocated to Montana between 19% and 30% of the total net income of the corporation in each of the tax years involved. This allocation has been made despite the fact that, in each of the years involved, the Montana ranching operations had no net income and in fact sustained substantial losses. During the same period, the sales of the products of the Montana operations were 1% to 7% of the total sales of the corporation, and the Montana payroll was 3% to 15% of the total corporation payroll.

This distortion is caused by the third factor of the formula — the property factor. The Montana ranch lands, livestock and equipment constitute a substantial portion of the Taxpayer's total property. The effect of the three-factor formula, given this fact, is to convert the tax from an income-based tax to a property tax at a time when the Taxpayer already pays taxes upon its real and personal property located in Montana.

The tax involved here is meant to be an income tax, to measure the amount of income earned in Montana. While the property factor no doubt contributes to the earnings of income from the Montana ranching operations, it is readily apparent that the ranching operations did not in fact generate income at all, much less 19% to 30% of the corporation's total net income.

The Department argues, in effect, that because this Court has approved the three-factor formula in principle, its application to concrete circumstances cannot produce a distorted allocation. Such analysis would eliminate the requirement of a rational relationship between the income

apportioned to a taxing state and the intrastate values of the enterprise. Such was the position of the Montana Supreme Court in its initial decision where it stated:

> The "rational relationship" requirement is met in this case also. Ward was operated as a unitary business and as discussed earlier its operation in Montana was both dependent upon and contributory to its operation outside the state. Therefore, the portion of Ward's total income attributed to Montana under Montana's three-factor apportionment formula is rationally related to the intrastate values of the corporation.

Appendix to the Jurisdictional Statement, p. 19.

While this Court has approved the three-factor formula in principle and recognized its utility in apportioning taxes, it has also noted that apportionment formulas can lead to distorted results. Accordingly, this Court has held that, when a Taxpayer produces evidence that the formula yields "a grossly distorted result in its particular case, the State is obliged to counter that evidence and to make accommodations necessary to assure that its taxing power is confined to its constitutional limits." *Norfolk and Western Railroad Company v. Missouri State Tax Commission*, 390 U.S. 317, 329 (1968).

Here, the allocation produced by use of the formula converts substantial losses in each of the tax years into significant amounts of net income, and it increases the tax due from the Appellant by between 521 and 896 times. Thus, the formula employed by the Appellee increases taxable income attributable to Montana and the tax to be paid by the Appellant in percentages which far exceed the percentage increases which led this Court to strike down state taxes in *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931) and *Norfolk and Western Railroad Company v. Missouri State Tax Commission*, 390 U.S. 317 (1968).

The decision of the Montana Supreme Court, if left intact, will sanction the elimination of the requirement of a rational relationship between income allocated to a state and the intrastate values of the enterprise. The position of the State of Montana in applying the three-factor formula in the face of the substantial distortion involved here raises a substantial federal question which requires plenary consideration by this Court for its resolution.

CONCLUSION

The Motion to Dismiss Appeal submitted by the Department of Revenue does not rebut the Appellant's position that substantial federal questions are raised. In view of the facts of this case, the position of the Department of Revenue, and the decisions of the Montana Supreme Court, this case raises substantial federal questions which merit plenary consideration by this Court.

Respectfully Submitted,

WARD A. SHANAHAN
Counsel of Record
DANIEL C. MURPHY
301 First National Bank Building
P.O. Box 1715
Helena, MT 59624-1715

Counsel for Appellant

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Pages misnumbered in original copy.

APPENDIX E

(Explanatory Note: The Witness is Mr. Jerome Keating, Controller of Ward Paper Box Co., the Taxpayer's predecessor in interest. The questioner is Mr. Ward A. Shanahan, Counsel for Taxpayer.)

(p. 171)

Box Company when these items were advanced to the ranch divisions?

A. No, sir.

Q. At any time?

A. At no time.

Q. Has the Department ever advised you that anything other than the three-factor formula was available for the computation of the tax in Montana under the unitary method?

A. They have not advised me.

Q. Between the box divisions, these divisions also have, as you testified — I think you said the same operational supervision, generally. The managers report to Mr. Bowers and Mr. Ward, is that right?

A. Yes, sir. The box divisions mostly to Mr. Bowers?

Q. And he spends most of his time on the box division business?

A. Yes, sir.

Q. How about public advertising, do the box divisions have joint advertising programs?

A. We have no advertising.

Q. Do they have any salesmen?

A. We do not have salesmen.

Q. Do they make common guaranties to customers?

(p. 172)

A. Do they make — no, sir.

Q. There are two that work different payroll records and tax reports, that's Smiley and Quincy?

A. Yes. They have their own accounting functions.

Q. They do all their own accounting altogether?

A. Yes, sir.

Q. And they're essentially autonomous?

A. Yes, sir, with the exception at Smiley we pay their bills. Quincy pays their own.

Q. Do personnel from various divisions of the box divisions move from one division to another?

A. No, sir.

Q. How about the managing staff?

A. No, sir.

Q. They've never moved from one to the other at all?

A. No, sir.

Q. Why was the Denver Division terminated?

A. It was not a profitable organization.

Q. They do exchange equipment, however?

A. Yes, sir.

Q. If there's a piece of equipment at one division that could be used at another, then it's moved over there and used?

A. Yes, sir. Mr. Ortega will buy equipment, overhaul it, repair it, and assign it to whichever division is

(p. 173)

necessary.

Q. Mr. Ortega is the general maintenance and engineering supervisor for the whole box division set up?

A. Yes, sir.

Q. Are there any other employees such as Mr. Ortega who do things for more than one box division?

A. No, sir.

Q. How about trucking facilities?

A. No common trucking facilities.

Q. They all have their own personal trucks for each division?

A. The smaller divisions do not have trucks.

Q. There are certain divisions that produce slightly different types of boxes than others?

A. Yes, sir.

Q. Would you explain what those are?

A. Smiley Container Division produces what's considered the heart-shaped boxes, specifically for Valentine's Day and some sales other periods of time.

Q. With respect to the heart-shaped boxes that are produced, what share of the market does that division have of all of the heart-shaped boxes in the United States?

A. Eighty to 90 percent.

Q. So it produces heart-shaped boxes for more than one candy company?

(p. 174)

A. Yes, sir. Brachs, McDonalds.

Q. As a matter of fact, there are some divisions that produce one size of heart-shaped box and another one produces another?

A. Yes, sir. Quincy Paper Box also produces heart-shaped boxes.

Q. Are there people who procure paper that is used commonly by all of the divisions?

A. By all of the divisions?

Q. Yes.

A. Smiley purchases their own. Quincy purchases their own. Ward Paper Box purchases for Ward, Clarksville, Marion, Montrose.

Q. Who makes those purchases?

A. James Dores (phonetical).

Q. Luehrs?

A. Luehrs.

Q. So he's a person who does a common job in purchasing materials and supplies for those divisions?

A. Yes, sir.

Q. How about such things as expendables, toilet paper, soap, cleaning compounds, that sort of thing?

A. That's purchased by the divisions.

Q. At the particular area?

A. Yes, sir.